THE REFORM OF CORPORATE REPORTING AND AUDITING

Testimony of
Baruch Lev*

Before the House of Representatives Committee on Energy and Commerce
(February 6, 2002)

* Philip Bardes Professor of Accounting and Finance, Stern School of Business, New York University (212-998-0028; blev@stern.nyu.edu; www.baruch-lev.com).

THE PROBLEM

FINANCIAL REPORTING

TOO NARROW

Reflecting:
Financial Aspects of Executed Transactions

Missing:
- Most Networking Activities
- Unexecuted Obligations
- Intangible (Knowledge) Assets
- Comprehensive Disclosure of Risk Exposure

AUDITING

TOO COZY

Due to:
- Auditors Effectively Appointed/Paid by Management
- Low Rotation, Excessive Consulting, and Jumping Ship
- Information-Challenged Auditor Report
- Auditing Standards Promulgated by Industry (AICPA); Peer Review Oversight

ENFORCEMENT

TOO LATE & OPAQUE

- Disclosure/Audit Failures Not Fully and Promptly Investigated
- Delayed Reporting of Trade by Insiders
- Investigative Material Largely Unreleased
- Litigation Settlements Kept Secret

THE SOLUTION

COMPREHENSIVE DISCLOSURE

Comprehensive Reports, Reflecting Financial & Nonfinancial Information Concerning:

- Executed Transactions (current system)
- Network Activities
- Unexecuted Obligations
- Intangible Assets
- Risk stress-tests

INDEPENDENT ASSURANCE

- Auditors Appointed by shareholders for a 5-Year Term
- Open-Ended Audit Report on Key Issues
- Consulting Capped at 25-30% of Audit Fees
- 1-Year Cooling-Off Period for Engagement partner
- A Joint Accounting-Auditing Standard Setting

QUICK-REPSONSE, TRANSPARENT INVESTIGATIONS

- Mandatory and Prompt Investigation of “Failures” by a New Body
- Transparency of Investigatory Correspondence and Findings
- Prompt Reporting of Insider Trading

E L A B O R A T I O N S

I. Corporate Disclosure: From Financial Reporting to Comprehensive Disclosure

21st century business enterprises are fast changing; involved in a complex network of alliances, joint ventures, partnerships and other related entities; and derive their value and growth primarily from intangible assets (patents, brands, knowhow, unique organizational designs).

The traditional accounting system, and its major product—the publicly-released financial reports—essentially reflect past transactions (sales, purchases, borrowing, etc.) only, and recognize physical and financial assets (plant and equipment, securities), to the exclusion of most intangible assets. Such narrowly-based, backward-looking corporate reports are ill-suited to provide the information needed by investors, creditors, and policymakers (e.g., for national accounting measurements). Primarily missing from current financial reports are:

1. Networking activities

A hallmark of the modern corporation is its involvement in a wide range of corporate activities conducted through alliances, joint-ventures, partnerships, and special purpose entities. For example, pharmaceutical, biotech, and chemical companies are conducting much of their R&D and marketing activities through alliances and joint ventures, as do software developers, and special purpose entities are often used to shift and optimize ownership and risk. There are solid economic reasons for most of these networking activities, although occasionally they are abused.

Most of these wide ranging activities are either ignored or improperly reflected in corporate financial reports, adversely affecting the information available to investors and creditors, and creating incentives for misrepresentation and fraud.

2. Unexecuted Obligations

The current, transaction-based accounting system practically ignores most unexecuted obligations and contractual arrangements, despite the fact that they can create major liabilities in the future.[1] Thus, for example, Enron's alleged obligations to cover SPE's losses were not reflected in its financial reports.

More broadly, firms' myriad unexecuted obligations to and contractual arrangements with alliance partners, suppliers, and financial institutions (e.g., debt securitzation) are deficiently reported, if at all. This creates significant incentives to misrepresent the true obligations profile of the company, and distorts the true economic situation of the enterprise.

3. Intangible Assets

In today's economy, physical and financial assets are largely commodities (i.e., competitors have equal access to them, such as Merck and Pfizer's access to the best lab equipment and information technology). Value and growth, of both corporations and nations, is primarily derived by unique intangible assets, such as patents, brands, and trademarks, as well as unique organizational designs (e.g., supply chains) and knowledge management systems.

The current, industrial era-based accounting system regards most intangibles as expenses, as if they were devoid of future benefits, thereby introducing serious biases to corporate balance sheets and income statements.[2] It has been empirically shown that

---

[1] An obligation is recognized in GAAP (generally accepted accounting principles) as a liability, only when a transaction (e.g., a purchase or a borrowing), or an event (a legally–binding fine) has already occurred.

[2] Particularly revealing in this respect is the fact that the current average market-to-book ratio (ratio of market value of companies to their net assets on the balance sheet) for the S&P 500 companies is over 5.0, implying that of every $5 of market value, only $1 appears on the balance sheet.

these reporting deficiencies cause serious social harms, such as excessive cost of capital, large insider gains, and manipulation of financial reports.[3]

4. Risk Exposure

The traditional accounting system, focusing on assets/liabilities and the outcomes of operations (income, cash flows) essentially ignores the risk exposure of business enterprises.

The fast growth of financial innovations in the last 20 years (derivative instruments for hedging and speculation, debt and other assets' securitization, employee stock options, etc.) expose companies and their shareholders to considerable and difficult to quantify risks. In the early 1990s, the SEC instituted various requirements for risk disclosure in prospectuses and financial statements. These, however, resulted in extensive yet largely meaningless boilerplate statements enumerating every possible risk "under the sun," and insufficient specific risk disclosures.

Particularly missing are results of comprehensive risk-related stress-tests, informing investors of the earnings and asset/liabilities consequences of expected changes in interest rates, foreign exchange rates, commodity (e.g., oil) prices, or changes in the economic conditions of countries where the company has major operations.

The Solution:

Current financial reports should be expanded to comprehensive disclosures, portraying in addition to the consequences of past transactions (the current system), a fair representation of the networking activities of the company, the obligations undertaken (executed as well as unexecuted), and its risk profile. Assets should include both tangible and intangibles. This is, of course a major endeavor, but a possible one, if such a comprehensive disclosure will be placed on the top of standard-setters (FASB, SEC) agendas.

[3] For elaboration on intangible assets, their sources and impact, as well as the reporting deficiencies and social consequences, see Baruch Lev, Intangibles: Management, Measurement and Reporting (Brookings Institution Press, 2001).

It is important to emphasize, particularly in the current Enron-intensive climate, that the major benefit of the proposed comprehensive disclosure system is to improve resource allocation in the economy and enhance the integrity of capital markets. The rooting of occasional misrepresentation and fraud is an important, yet secondary objective.

II. Auditing

The auditing of public companies by external auditors is in many cases an "all in the family" affair. Auditors are in too many companies effectively appointed and reappointed by managers, who also have a significant say in the audit fees.[4] Auditors' rotation is very low; quite frequently auditors serve the same company 10-20 years, or more (much of the auditors' rotation, as is, is due to frequent mergers and acquisitions by companies rather than to inadequate service.) Cases in which auditing personnel switch without a cooling off period to work for clients proliferate, as are cases in which auditors engage in lucrative consulting with audit clients. Such close arrangements and relationships between auditors and auditees are manifestly inconsistent with independent, effective and high quality auditing services.

Yet another dimension of the "all in the family" is the fact that the auditors' trade association—the American Institute of Certified Public Accountants (AICPA)—is in charge of promulgating auditing standards (GAAS), on which in turn, the audit report relies. This uniform report is long on hedging (e.g., "the financial statements are the responsibility of the Company's management") and short on information relevant to investors and creditors. To top it all, the industry oversight is performed by "peer reviews" conducted by other auditing firms. It was widely reported in the media that in the last two decades this peer review did not publicly sanction a single "big five" accounting firm.

[4] Formally, the board's audit committee is primarily involved in auditors' appointment, and their reappointment is approved in the annual shareholders' meeting. In many corporations, however, these are just formalities.

The Solution: A substantive revamp of the auditing industry along the following lines.

- Auditor selection by shareholders. This is a drastic change from the current procedure, where managers and board members effectively select and reappoint auditors. Shareholders, using a process similar to the frequently used "proxy contest," will be asked to appoint auditors, based on competitive bids, for a five-year term. Only such an appointment will effectively sever managers-auditors link. Some argue that this can be achieved by the board's audit committee. But board members are also selected by managers.

  It's easy to dismiss this proposal by saying that shareholders don't have the required information to make auditor choices. Such a condescending approach ("we know, but owners don't") is flawed on its face. In addition, Hewlett Packard (H-P), for example, will soon put to a shareholder vote the largest acquisition ever in the high tech sector (Compaq). If shareholders can be trusted to make such a complex decision, why can't they be trusted to choose auditors. Of course, the main choice will be made by the generally well-informed institutional investors who are holding large blocks of shares, in most companies.

- Consulting to audit clients. It's attractive in the current climate to demand a complete ban on consulting to audit clients. I prefer a consulting cap of 25-30 percent of audit fees. The reason: As an educator, I can testify to the considerable difficulties accounting firms encounter in attracting young, qualified personnel. Put plainly—it's not very attractive to work for accounting firms, particularly post-Enron. It is, therefore, important to retain elements of challenge and excitement in the accounting career. Consulting provides such an element.

- Jumping ship. Engagement partners (the people in charge of the audit) should not be allowed to switch employment to clients, without a cooling-off period of a year, at least.

- An expanded audit report. The current, information-challenged audit report should be replaced with an open-ended document, where auditors report to shareholders and creditors on various key subjects, in addition to the conformity of financial statements with the company's financial position (the current report). Such key issues include the adequacy of corporate governance systems and internal controls, unusual risks facing the company, and questions and suggestions raised by auditors in the audit process, but left unanswered by management. Of course, if auditors will be selected by shareholders, additional tasks can be placed on them (e.g., report on the consequences of mergers and acquisitions).

- Joint accounting-auditing standard setting. Accounting standards are set by the FASB, and auditing standards by the Auditing Standards Board (ASB), affiliated with the auditors' trade group—the AICPA. Since financial reporting (accounting) and auditing issues are intertwined, it makes sense to combine these activities in one standard-setting body.[5] Such a joint standard-setting process will have the added advantage of detaching the setting of auditing standards from the industry.

- A need for oversight? The peer review oversight of audit firms is currently much maligned. What should replace it? Perhaps nothing. The above mentioned proposals, if instituted, will create a vibrant, truly competitive and independent auditing profession, that probably does not require a formal oversight beyond the current SEC, courts, and shareholders having a real power to remove auditors.

III. Enforcement

Two important elements are currently missing, in my opinion, from the auditing-accounting enforcement systems: a quick-reaction investigatory body and transparency.

- Quick-reaction investigation body. This suggestion was raised by several commentators on the Enron case. The proposal is to establish an organization that will promptly and thoroughly investigate corporate accounting/auditing failures, and make the findings publicly available. I strongly endorse this suggestion, and add several elements.

[5] For example, the FASB has recently added to its agenda the "intangibles disclosure" item. Surely, questions concerning the disclosure of intangibles (e.g., the value of a patent portfolio), depend in part on the auditability of the disclosed items.

Investigation cases should not be limited to "post mortems," such as Enron. They should start much earlier in the process and thereby retain the important preventative element. For example, every case of significant restatement of earnings (numbering in the hundreds each year) should be investigated. Also, employees, like Enron's Ms. Watkins, could ask for this body's investigation.

I propose that this investigative body be independent of the SEC, and funded by a miniscule levy on stock trade. After all, investors will be the main beneficiaries of this body. An idea for funding: Total number of shares traded in the U.S. during 2000 was 718 billion shares. A levy of 1 cent per 100 shares will raise $71 million a year, sufficient to fund an active and efficient investigative body (the National Transportation Safety Board's recent annual budget was $57million).

- Transparency. Much of the examinations and investigations currently conducted with respect to financial reporting and auditing issues is not open to the public. Consequently, such investigations contribute little to learning and deterrent in capital markets, in corporate boards and accounting firms. For example, most of the correspondence between the SEC and public companies is closed to the public, as are securities litigation settlements (over 90% of securities lawsuits).

  I propose to thoroughly review the SEC disclosure procedures, and increase significantly the transparency of correspondence and investigatory material, unless it is highly likely harmful to companies and their shareholders.

- Not directly related to accounting/auditing, but very important nevertheless is a prompt reporting of insider trading. Currently there is a lag of 20-25 days on average, between trade and reporting to the SEC. There is absolutely no justification for such a long delay. Insider (e.g., corporate officers and board members) trading should be electronically reported to the SEC and made public no later than the day following the trade. This will alert investors and creditors in real time to important information available to managers.

IV. Postscript

The analysis, proposals and suggestions outlined in this document are not just aimed at preventing future Enrons and its audits. More broadly and importantly, they are aimed at enhancing corporate disclosure and the effectiveness of audits, which are necessary conditions for a fast growing economy, well-functioning capital markets, and ethical and equitable corporate behavior. The pursue of these high level social goals, is the major purpose of the proposed corporate reporting and auditing reforms.